

## APPENDIX

Notes for FOMC Meeting  
August 19, 1986

Sam Y. Cross

Since the last FOMC meeting, sentiment toward the dollar has grown increasingly negative, and the dollar declined throughout the intermeeting period. As expected at the last Committee meeting, neither Germany nor Japan followed the U.S. discount rate cut of July 11. But also neither France or the U.K. followed, inasmuch as the authorities in those two countries felt constrained by the sudden weakening which occurred in their currencies against the mark. In the ensuing weeks, with the market reflecting on the prospect of further U.S. monetary policy moves independent of other countries' actions, the dollar passed through a succession of new postwar lows against the yen and reached a 5-1/2-year low against the German mark. On balance, the dollar lost about 4-5 percent against most major currencies during the past six weeks.

It is useful to look back over the developments since last September's G-5 meeting at the Plaza, when the G-5 authorities committed themselves to the goal of sustained and more balanced economic growth. As you recall, the dollar was then trading around DM 2.90 and Y 242. In the three months following that meeting, there were coordinated intervention sales of dollars by the G-5 countries totaling \$8.5 billion to resist persistent and at times intense upward pressures on the dollar.

These upward pressures dissipated in due course, as the market became convinced that the authorities were committed to a lower dollar, and as the relative financial attractiveness of dollar investments declined. At the time of the Plaza agreement, long-term interest differentials were favorable to the dollar by a large margin

of 3-1/2 to 4 full percentage points against comparable mark and yen investments. By July these differentials had shrunk to their lowest levels in more than six years.

In these circumstances, the intervention activities of the G-5 have turned around. During the past four months, G-5 central banks have shifted from selling dollars net to buying dollars, and have acquired net more than \$14.5 billion in the exchange market. The Japanese alone have purchased nearly billion since mid-April, some times the amount of Bank of Japan dollar sales in the coordinated intervention of last autumn. While the Bundesbank has not turned to dollar purchases, market participants remain alert to the possibility of German intervention.

The dollar is now 30 to 35 percent below its pre-Plaza levels against the mark and the yen, and the perception is that the dollar will weaken further. The monthly trade figures--which continue to show record or near-record imbalances for the United States, Japan and Germany--have done little to dispel the strong political and protectionist pressures. Economic statistics show little revival of growth in the United States or in our export markets abroad. And the market believes that the U.S. authorities would welcome further depreciation of the dollar, partly as a means of pressing foreign authorities for economic stimulus that would increase worldwide demand. Also, participants have noted the attractiveness of the mark as an investment instrument, and have reported increased investment flows into Germany, where the bond market has rallied in recent weeks. On the other side, tending to keep the dollar from sliding, market sources remain wary about official intervention and are weighing the possibility that the Bundesbank might be more receptive to a discount rate cut this fall than earlier. At this juncture, we have avoided

the big sell-off of the dollar that has been feared. Still, the condition of the dollar remains tenuous.

Peter D. Sternlight  
Notes for FOMC Meeting

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Domestic Desk operations since the last meeting have been directed at maintaining the more accommodative posture adopted at the July meeting and embodied in the 1/2 percentage point reduction in the discount rate shortly after that meeting. Reserve pressures, as measured by the volume of adjustment and seasonal borrowing allowed for in constructing the nonborrowed reserve path, held at \$300 million, unchanged from before the July meeting, although one might say there was a slight nod to the accommodative side in that part of the adjustment borrowing in the latter part of the interval has reflected "special situation" borrowing by troubled oil-region banks. The Desk made some rough allowance for this in interpreting and responding to day-to-day reserve needs but the allowance tended to fall somewhat shy of the actual pace of such borrowing.

Under this approach, federal funds rates worked lower, from about 6-3/4 - 7/8 percent at the time of the last meeting--and just before the discount rate cut--to around 6-1/4 - 3/8 percent in recent days--although with some firming last Friday, a heavy Treasury settlement day compounded by wire problems. Borrowing was close to the \$300 million path level in the first maintenance period, ending mid-July, and then closer to \$400 million in the next two full maintenance periods. After taking account of special situation borrowing, however, borrowing in the latter two periods was close to \$300 million and just modestly over \$200 million. So far in the current reserve period, borrowing averaged about \$560 million, reflecting a pickup in last Friday's firm money market; a little over \$200 million of that \$560 million reflects "special situation"

borrowing. In both the first and third periods, nonborrowed reserves turned out below path, with demand for excess reserves running to the low side, and with effective nonborrowed reserves in the third period bolstered somewhat by the special borrowing noted earlier. In the middle period, nonborrowed reserves were somewhat above path and excess reserves also ran high.

The Desk faced sizable reserve needs early in the inter-meeting period, and then more moderate but still fairly persistent needs as the interval progressed. Bills were purchased in small amounts from foreign accounts on most days, aggregating to about \$1.3 billion over the period. About \$90 million of this outright increase in holdings was offset by a run-off in Federal agency holdings as the agency in question did not offer a replacement issue with the same payment date as the maturing one. Repurchase agreements were arranged on most days--including three rounds of System agreements early in the period when needs were relatively large, and customer-related agreements to meet the more moderate needs on many other days.

Interest rate changes over the period tended to steepen the yield curve, with moderate net declines at the short end and little change or modest increases at the long end. The discount rate drop near the opening of the period had only a small impact, mainly at the short end, as it was widely anticipated. Intermediate and longer rates backed up toward midperiod, as the Treasury's big quarterly financing approached, particularly once it became clear that debt limit restraints would not interfere with the auctions. At the same time, there were doubts about whether Japanese interest would be as robust as in May for the 10- and 30-year issues. Firming oil prices, and some data suggesting the economy might not be so weak as some had contemplated also had a dampening effect on the bond market just

before the auctions. Once rates had backed up, reasonably good interest did develop in the auctions. This included good interest from Japanese buyers--though it was somewhat less than in May.

After the auctions were over, market attention turned again to the "fundamentals" of perceived sluggish economic activity and apparently subdued inflation, and good retail buying helped to move dealer supplies into investors' hands at higher prices. Late in the period, the market also rallied on speculation of fresh accommodative moves by the Federal Reserve, possibly in coordination with other countries. The improved sentiment lifted prices of the newly auctioned Treasury financing issues to levels well above their auction averages, with yields down about 25-35 basis points from the auctions. For the full period, yields on short- to intermediate-term Treasury coupon issues were down about 15 to 35 basis points, although the reopened 30-year bond rose about 15 basis points in yield over the period, while other long-term issues were about unchanged. The Treasury continued to concentrate its net cash raising in the coupon sector, borrowing a net of nearly \$16 billion through coupon issues over the period, much of it in the record \$28 billion quarterly financing that settled last Friday.

In the Treasury bill area, rates on key issues were down about 25 basis points, with the Treasury raising about \$4-1/2 billion in this sector. Cash raising in bills was limited by debt ceiling constraints in mid-August, as the Treasury cut back on bill issues to make sure it could stay within the legal ceiling while also tapping the coupon market in line with longer range plans. Congressional action in the wee hours last Saturday has provided some relief regarding the debt limit, with a \$32 billion increase that should take the Treasury up to about the end of September. In yesterday's bill

auctions, three- and six-month issues were at 5.64 and 5.65 percent, compared with 5.85 percent for each issue just before the last meeting.

Current fixed income market sentiment seems to be on the moderately bullish side, anticipating somewhat lower rates in the context of a sluggish economy and dormant inflation. There is a fairly widespread expectation of another discount rate cut in the next month or so. At the same time, a number of market observers seem to feel that the next cut could be the last, as they anticipate that business activity and price pressures could pick up a bit heading into next year.



Peter D. Sternlight  
Agenda Item on System Portfolio and Coupon Purchases  
August 19, 1986

A question naturally arises as to why this subject is on the Committee's agenda at this time. The chief reason is that on some recent occasions when Desk operations in coupon issues were undertaken, or contemplated, basic questions were raised as to the need for, or desirability of, such operations. Besides, it's probably a good idea to take a fresh look at subjects like this from time to time.

The paper circulated to the Committee last week attempts to set out the pros and cons of continuing the moderate coupon issue purchase program of recent years. Possible alternatives could include scaling that program up, down, or perhaps out. The paper also notes the possibility of having the System Account accentuate its recent tendency to place greater emphasis on the shorter term maturities offered in the Treasury's major quarterly refundings, in order to ensure the continuing ample liquidity of the System's holdings.

In the view of the Account Management, the preferable course regarding coupon purchases would be to continue the approach followed in recent years, which I would describe as one of moderate occasional purchases. Typically, in each of the last several years, there have been two, or perhaps three, trips to the market to buy coupon issues, amounting to about \$3-4 billion annually. Typically, this constituted about 20-35 percent of the annual increase in the portfolio, and was a much smaller proportion of the amount of net new coupon debt being issued by the Treasury.

Looking at the five years from the end of 1980 to the end of 1985, the purchases of several billion a year in coupon issues still permitted the proportion of bills in the portfolio to rise--from about

36 to 47 percent. By mid-86, with no coupon purchases since last December, that proportion was 48-1/2 percent. Taking another measure that includes coupon issues maturing within a year along with bills, the proportion of Treasury issues due within a year has increased from about 45 to 59 percent of our portfolio.

Frankly, I've found it hard to come up with strong arguments against occasional coupon purchases. True, on any particular occasion, it's also hard to argue that it's important for the Desk to buy coupons rather than bills. But in a longer-run context, I think there are good arguments, as outlined in my note to the Committee, for continuing to keep in touch with the coupon market on an occasional basis.

I'd welcome your questions or comments on whether the approach we have been taking should be continued.

J. L. KICHLINE  
AUGUST 19, 1986

# FOMC BRIEFING

The staff's forecast of the economy is virtually unchanged from that presented at the last meeting of the Committee. The information that has become available over the past month or so has done little to clarify the major issues in the projection, but has been broadly consistent with the notion that we are in a period of moderate, although very uneven, growth. Real GNP in the current quarter is projected to expand at a 2-1/2 percent annual rate and to move above 3 percent late this year and through 1987. Price inflation is projected to average 2-1/2 percent over the second half of this year and somewhat higher next year.

This morning the Commerce Department released revised national income account data for the second quarter. Real GNP is now reported to have expanded at a 0.6 percent annual rate, one-half percentage point less than estimated previously. Net exports and inventories were revised downward, while consumption and government spending were raised. The rise in the deflator, at a 2-1/2 percent annual rate, is now a few tenths higher than earlier. These revised data largely were anticipated when we prepared the

forecast, and thus do not provide information that would argue for an alteration of the projection.

For the current quarter one of the key pieces of information is the July labor market report. It showed payroll employment growth of nearly 1/4 million after adjustment for strikes--appreciably above the average monthly gains during the first half of the year--and the unemployment rate edged down 0.2 percentage point to 6.9 percent. As has been the case for some time, employment growth was concentrated in the trade, service, and finance sectors while manufacturing registered another drop.

Weakness in the manufacturing sector is reflected, of course, in the performance of industrial production. During July, the industrial production index edged down 0.1 percent and for the past three months is down about a percentage point. The direct effects of declines in petroleum drilling have been waning, but weakness persists in the output of business equipment and consumer goods. At this juncture, it seems quite likely that industrial output this quarter will register another decline on average, but with generally lean inventories, increasing competitiveness of domestic manufacturers, and growth of final sales the stage is set for a rise of industrial production by the fall.

Consumer spending has been a strong point in the economy so far this year. In the forecast for the second half of this year, we anticipate a slackening of growth consistent with somewhat slower expansion of real disposable income. In July, total auto sales declined a bit from the pace in the second quarter, owing to a fall in sales of domestic models. In light of high domestic auto inventories, it seems likely that more generous sales incentive programs will be announced and perhaps assemblies cut back a little from current industry plans. But outside of autos and nonconsumer items, the retail sales report for July was strong, and spending in May and June was revised upward as well. If these data hold up with subsequent revisions, the staff's consumer spending forecast of 2-1/2 percent growth at an annual rate this quarter requires little further rise in retail sales over the balance of the quarter.

Unfortunately, in the investment sectors we have no broadly based evidence on developments this quarter. Residential investment outlays should contribute to economic growth this quarter, given the large volume of housing starts earlier this year. However, this sector's contribution is projected to weaken over time as high rental vacancy rates and tax law changes take a further toll on multifamily construction. For business fixed investment, orders for equipment through June give a sense of halting

their decline while commitments and spending for structures continue to fall. The staff forecast entails a small decline in business fixed investment over the second half of this year.

On the whole, the evidence is not yet in hand to suggest that the economy is solidly on a path of higher growth. Our analysis, however, continues to point in the direction of some slackening of domestic demand expansion, improvement in the trade sector, and overall a better balanced and stronger expansion in domestic production.

Briefly, on the price situation, recent monthly indexes have fluctuated largely in response to developments in food and energy prices. Food prices in the aggregate are rising this quarter in response to higher livestock and poultry prices which appears likely to be a temporary phenomenon. In energy markets, however, this quarter could see the end of price drops and oil prices are anticipated to retrace some of the recent decline later this year and into 1987. The recent OPEC agreement on production cuts, to the extent it is successful, should help soak up excess world supplies and lead to higher petroleum prices. The staff assumes oil prices will move to \$16 per barrel early next year. Outside of food and energy, the direct and indirect effects of higher import prices are projected to feed through to somewhat higher inflation in 1987.

The discussion of the alternatives in the bluebook has been oriented more toward the implications for the broader monetary aggregates, given the Committee's decision not to set an explicit numerical objective for expansion of M1 in the third quarter and 1986. The marked acceleration of both M2 and M3 in July, along with the upward revisions noted in the bluebook, boosted these aggregates much closer to the upper ends of their long-run ranges; at the same time M1 also strengthened, and its growth rate in July was close to the extraordinary pace of the second quarter. Growth in the broader aggregates is expected to moderate substantially in August and September, however, under all the alternatives, keeping M2 and M3 within their long-run ranges by September. The staff expects these aggregates to stay in the upper portions of their ranges over the balance of the year if interest rates remain around current levels or move slightly higher, but they could be considerably closer to the upper ends than anticipated at the last meeting. Should rates drop somewhat further, the odds on growth around or even above the upper ends of the ranges--especially for M2--appear much higher. In these circumstances, it may be helpful as background for Committee discussion to review the prospects for the broader aggregates and the possible implications of more rapid expansion.

With respect to M3, there are reasons to be a bit less concerned about the potential for outsized growth. Rapid expansion of M3 in July follows months of more modest growth, and reflects in part the funding of an unexpected surge in security acquisitions by banks. Another such bulge is not considered likely, and bank credit growth should drop back to a more moderate pace over the balance of the quarter and the year, even if interest rates were to decline. In these circumstances, the effects on M3 of any

sharp pick up of inflows to core deposits at banks might tend to be offset by cutbacks in managed liabilities.

The behavior of thrift institutions would seem to pose a bigger threat of an overshoot in the M3 range, however. New Bank Board capital requirements geared to growth in balance sheet footings now are scheduled to go into effect in January, giving thrifts some incentive to build up their balance sheets before year end. Moreover, the securitization of thrift mortgage portfolios has given them increased opportunities to finance with RPs--as was reflected in the upward revision to M3--rather than, say, FHLB advances which do not have a counterpart in M3. The economic significance of an overrun in M3, particularly for these reasons, might be open to question. The behavior of this aggregate seems to depend to a considerable extent on the credit and funding decisions of depository institutions, which may be more related to regulatory constraints or relatively small changes in cost relationships than to underlying economic prospects.

The odds on a substantial overshoot of the long-run M2 range seem a little higher, especially if interest rates fall further. Abstracting from the recent fluctuations in June and July, the underlying growth in this aggregate has been very strong for some months. M2 less overnight RPs and Eurodollars has been expanding at a 12 percent annual rate since March, considerably above its growth rate early in the year. This performance probably represents to some degree shifts from market instruments into M2 deposits and money market funds as market interest rates have come down faster than the yields on these instruments. Should interest rates drop further, M2 growth could remain especially rapid if depositories



prove reluctant to lower offering rates on regular NOW and savings accounts. Whether, in addition to shifts of funds toward M2 components, the strength in M2 also signals a more general rapid build up in the public's overall holdings of liquid assets is not clear. Data on L lag those on the other aggregates but from the fourth quarter through June this aggregate grew at a 7-1/2 percent annual rate--about a half percentage point below the growth of M2 and M3 over the same period.

Evidence on whether a sustained surge in M2 might presage a later surge in spending is mixed. Generally, when both M1 and M2 have accelerated, a pick up in GNP has followed, but the dimensions of such a strengthening are not clear. M2 has performed considerably better than M1 over the 1980's in various statistical tests of its demand functions and its ability to predict GNP. But the errors are still quite large--on the order of 3 to 4 percent per year in simple reduced-form equations predicting GNP. Moreover, simple inspection of the data over recent years would suggest that the movements in M2 are not well correlated with the behavior of the economy. On an annual basis growth of M2 has been fairly steady since the advent of MMCs in 1978, averaging only between 8 and 9-1/2 percent apart from 1983 when MMDAs were introduced; over the same period, growth in GNP has ranged from 3 to 15 percent, and M2 velocity has fluctuated from plus 6 percent to minus 5-1/2 percent. That record seems likely to be extended this year, as the effects of the decline in interest rates offset the impact of the sluggish growth in nominal income, producing in all likelihood the largest drop in velocity since the recession year of 1982--on the order of 3 to 4 percent. Rapid growth of M2 may not imply an undue boost to GNP in the future if the decline in interest rates that induced it results largely from adjustments of nominal rates to lower inflation, or of real rates to

underlying weakness in economic activity, or some of both, rather than a product of overly stimulative monetary policy. That is, M2 behavior, though to a lesser extent than the much more interest-sensitive M1, cannot be judged apart from the surrounding economic circumstances, and the circumstances currently prevailing may be interpreted as implying that a tendency for M2 to run near or even above its target range would not necessarily be cause for alarm.

However, continuing rapid M2 growth does imply a hefty build-up in a subset of the public's liquid assets that has over a period of years moved together with income; for all its ups and downs, the level of M2 velocity is little different than it was many years ago. The M2 expansion seems especially substantial when viewed in real terms, given the relatively modest movement in price levels this year. Moreover, the directive and public statements of the Committee have repeatedly stressed that outsized growth in M1 would be judged in light of developments in the broader aggregates. Should M2 or perhaps M3 threaten to exceed their ranges without some form of countervailing action by the Federal Reserve, the Committee could be seen as de-emphasizing one or both of the remaining intermediate monetary objectives for which it has not yet declared its willingness to tolerate growth outside of established ranges.

Of the bluebook alternatives, C implies the greatest degree of concern about the potential for money growth above the Committee's ranges for the year. The moderate tightening of reserve conditions envisioned under this alternative would restrain money growth both in the near-term and in the fourth quarter as well, providing some additional assurance of remaining within the ranges of the broader aggregates for the year.

Alternative A, on the other hand, which would involve some decline in interest rates, might be viewed as implying greater concern about the potential for a shortfall in economic activity and strains on the financial system. The more rapid money growth that could result under this alternative--including the possibility that the broader aggregates would overshoot their ranges for the year--might be considered as an acceptable byproduct of keeping GNP on a satisfactory track, given the needed decline in rates. Alternative B obviously could be viewed as striking a balance between the risks addressed by alternatives A and C, perhaps in the context of awaiting further evidence on trends in the aggregates and the economy.